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THE ELASTICITY OF NOTE ISSUE UNDER THE NEW CURRENCY LAW

To anyone who has been interested in currency reform for, say, twenty years, probably nothing is more striking than the change in emphasis which has taken place among the advocates of reform during this period. The typical reform plan of the earlier time, for example the so-called Baltimore plan brought forward in 1894, devoted itself almost exclusively to providing a thoroughly elastic note issue, based on ordinary assets. In contrast, the new law has as its central, primary object the organization into at least regional unity of something like the entire banking system of the country. Doubtless this difference in the two reform plans was not altogether due to a fundamental difference of opinion with respect to what would be the ideal scheme. The reformers of the earlier period were not indifferent to the need for centralized organization in the banking system. But they considered any scheme involving a central bank, like the old Bank of the United States, quite chimerical; and they were probably right. But times change; and men change with them. For one reason or another we have all become more tolerant of centralization in business matters, as also more tolerant of that increase in governmental control which increased centralization in business seems to make necessary. With at least fairly general approval, a system of regional organization has been set up, involving a very high degree of centralization and a very high degree of governmental control. But with this change in the method of reform, it became inevitable that the more important ends which earlier schemes sought to accomplish by giving the note a high degree of elasticity should be, in no small measure, attained by other means. In consequence, the need for elasticity in the note issue will be much diminished under the new law. Nevertheless, it is admitted that this need will not disappear altogether. Elasticity in the note issue will be wanted partly to assist in utilizing the newer methods of dealing with the difficulties involved and partly to supplement those newer

methods. Accordingly, the question "How far does the note issue under the new system seem likely to prove an elastic one?" is still important.

From the beginnings of agitation for currency reform the advocates of elasticity have recognized more or less clearly two kinds: (1) what we may call *seasonal* or ordinary elasticity, and (2) what we may call *emergency* elasticity. By the former was meant the power of a note issue to adjust its volume to those moderate changes in the need for money which show themselves in the course of an ordinary year. By emergency elasticity was meant the power of a note issue to adjust its volume to those extraordinary changes in need which connect themselves with the typical banking panic. The evils which it was believed that seasonal or ordinary elasticity would remedy were principally (1) the summer shortage of currency for moving crops, together with the temporary but more or less serious stringency in the New York money market which accompanies that shortage, and (2) the plethora or excess of currency which usually appears three or four months after the crop-moving period has terminated. The evils which emergency elasticity was expected to relieve were principally (1) the stringency which precipitates the panic, (2) the money famine consequent on general bank suspension after the panic has fully developed, and (3) the glut of currency which attends the depression following a panic, often leading to excessive exports of gold and thus endangering the whole credit system of the country.

Let us, now, take up seasonal or ordinary elasticity, and ask ourselves whether the new notes are likely to possess this characteristic. First, how about the expansibility needed to supply adequate funds for crop-moving? At this point, it must at once be admitted that the new currency does not meet the demands of the case in quite the thoroughgoing way which the earlier schemes thought to be necessary. The ideal of the earlier plans was to provide an adequate and easily utilized power of issue, located at the very place where the need for expansion is felt, i.e., in the local bank. The new law gives up this idea entirely. The local bank will not have power to issue the new currency at all. In so far as its customers are to get any benefit from that currency the

benefit must come through two channels which the country bank could use in getting the needed funds, even if the currency had no expansibility, namely, (1) calling in its balances kept with banks more centrally situated, and (2) borrowing from such central banks. In other words, the new power of issue will help out in the crop-moving period merely because it will put the reserve banks in a better position to respond to the call of the country banks for the return of their own balances and for advances on discounted paper. Judged from this point of view only, the elasticity provided by the new law is doubtless adequate. If the reserve banks have not kept themselves in a position to meet the calls of their country members from money already in possession, they will surely be able to put themselves into such a position by expanding their issue of notes. In one sense, then, the new issue has adequate expansibility for ordinary needs. There still perhaps remains a doubt whether effective elasticity is after all assured, for it is not clear that the country bank which needs money for crop-moving purposes will have the wherewithal to get advances from the reserve bank—that is, that it will have paper of the proper kind and in sufficient amount for rediscount. However, it seems probable that the act as finally passed has met this need by providing that agricultural paper shall be admitted on rather more liberal terms than paper arising out of ordinary commercial or manufacturing business. If this be so, it would seem that the provisions of the new law for securing one phase of seasonal elasticity—expansibility—are fairly adequate.

Passing, now, to the other side of elasticity—i.e., contractility—can we say as much? Will the new issues promptly retire when their special task is over? *Prima facie*, the verdict here is less favorable than in the previous case. In general, there are two principal processes by which a note circulation may be contracted: (1) *driving* the notes out of circulation, and (2) *drawing* them out. In so far as the former process is depended upon, means are devised to make sure that the notes shall persistently return to the issuer even against his will—they shall have good homing power. By the second process, it is made to the advantage of the issuer of the notes to hasten their withdrawal himself.

As respects insuring contractility by the former of these processes, the act certainly cannot claim to promise high efficiency. The driving-out process requires roughly the fulfilment of two conditions: (1) keeping the channels for the return of notes to the issuer fairly open, and (2) supplying outsiders with a motive for sending the notes home. As regards the former of these conditions, the new system probably is all right. The return of the notes to the issuer seems not to be impeded by the inconvenience or expensiveness of the process. All member banks and all reserve banks must receive these notes; and the reserve banks will probably have branches within easy reach of any part of the district. Hence, any holder desiring to get notes back to the issuing bank will find the process easy and the way open. But good homing power requires more than this. It requires, namely, that adequate motives be supplied to people generally, or, at least, to banks generally, for seeing that the notes get back. It is not enough that the track be smooth; people must desire to use it. Now, earlier plans for securing elasticity relied on two principal motives for inducing holders to send notes back to the issuer: (1) the desire of such holders to make room for their own notes, and (2) their desire to exchange money which has various limitations imposed upon it for money which is free from those limitations. It is plain that the new system makes only a limited use of the former of these methods of procedure. *Within* the district for which any particular reserve bank is the central bank, this particular force will be practically inoperative; for the power to issue notes on the basis of common assets is not given to any but the reserve banks, and the profitableness of the power to issue the old type of note has always proved too low to induce banks generally to take much trouble to get their own notes into circulation. As between the reserve banks of the different districts, however, this particular motive will, of course, be more or less in evidence, since these reserve banks will all be competitors for this opportunity. But even here the motive in question will not play a large part, since more effective means for insuring the return of the notes from outside reserve banks are provided in other parts of the law.

As regards the second motive for returning idle notes—that is, the desire to exchange a money subject to various limitations or disabilities for one not subject to those limitations—the new act does somewhat better than it does in respect to the first motive. It is, indeed, true that, within their own district, no special disability, like being forbidden to be paid out by other banks, is put on the new notes. But they are always subject to the disability of not being legal reserve money in the case of federal banks; and hence such banks will be more or less disposed to return the notes issued by their own reserve banks, in order to exchange them for reserve money. It may be doubted, however, whether in ordinary times this will prove a very potent force, since country banks will usually keep reserves considerably in excess of legal requirements, and so will not need to discriminate nicely between the two sorts of money. As between different districts, the case for the homing power of the new notes is rather stronger, since reserve banks are prohibited from paying out the notes of other reserve banks under penalty of a 10 per cent tax. Even here, however, the provisions are none too adequate. While the notes of a particular reserve bank must not be paid out by the reserve banks of other districts, there is no prohibition against their being paid out by the member banks of other districts; and it is doubtful whether there is sufficient motive to induce said member banks of other districts to send in these notes to their own reserve banks and so start them on their homeward journey. The desire to exchange money which cannot be used as reserve for that which can be would have some force; but, under many circumstances, it would probably prove rather inadequate.

Another disability which contributes to the homing power of a bank note, and which is actually used in the case of our old note, is not used with this new note—I mean, the fact that they are not receivable for customs dues. The decision to omit this provision was perhaps wise; but it throws out a potent motive for sending notes home, and thus throws away an opportunity to make better provision for their contractility. On the whole, then, it must be acknowledged that, in so far as homing power is dependent on

giving to outsiders strong and persistent motives for sending notes home, the new law is not altogether satisfactory.

We have seen that there is very little in the new system to secure that the notes shall have good homing power—shall get home by what we have called the *driving-in* process. Is the system better off as respects the *drawing-in* process? Are matters so arranged that the issuing bank will have the power and the desire to withdraw its notes—or at least contract the currency proportionately—when the need for the notes has fallen off? As respects the first part—making sure that the issuing bank shall have the power to retire its notes, or at any rate to effect a corresponding contraction of the currency—the new system is practically perfect, as indeed was the old one. That is, any reserve bank desiring to contract its note obligations may at its discretion deposit with the federal reserve agent reserve notes, gold, or lawful money. Obviously, this, if not strictly a contraction of its note circulation, at least brings about the desired contraction of the general circulation.

When, however, we consider the provisions of the new law for insuring that reserve banks shall desire to contract their circulation when the special need has passed, we find that the law does not promise quite so well. The favorite device for accomplishing this result has been, of course, a tax on issues, similar to the 5 per cent tax of the German system. Apparently, the new law provides for something equivalent to this in the shape of an interest charge by the Federal Reserve Board, the rate to be fixed by said board. How far this device will prove effective in practice it is not safe to predict. In order that it should induce the banks to contract their circulation, circumstances must have arisen under which the issuing bank would be earning on its outstanding notes a profit smaller than the tax itself. Now, it does not seem certain that an excessive issue of notes would necessarily bring about this condition. In the first place, in the absence of good homing power, a volume of notes in excess of business needs would not necessarily cause an accumulation of those notes in the vaults of the bank issuing them. Secondly, so long as member banks are free to keep their balances in banking institutions other than their reserve banks, an excess of notes would not necessarily cause the general

cash holdings of reserve banks to be abnormally large. For, so long as the ordinary New York banks are permitted to pay interest on bankers' balances, country banks will to a considerable extent keep their balances with these outside New York banks; and it seems not unlikely that the excessive monetary stock thus accumulating in New York City would, instead of getting into the hands of the New York reserve bank, largely remain in the hands of the outside banking institutions and be employed more or less as it has been in the past, that is, in financing doubtful enterprises and supporting excessive speculation. But if the reserve banks do not feel the pressure of excessive issues in the shape of accumulations of notes or some form of money in their own vaults, they may conceivably be able to invest advantageously all the funds in their possession, and, in that case, the rate of interest charged by the Federal Reserve Board will not furnish an adequate motive for the retirement of their issues. Doubtless, however, this may in some degree be answered by saying that even an excess which was felt only outside the reserve bank would, after all, compel the reserve bank to contract its issues, since it would lower the rate of discount so greatly that reserve banks could not profitably invest their ordinary holdings, and consequently would wish to get rid of the interest charge. Perhaps this is true; but it would by no means insure the prompt and full contraction which most reformers have considered desirable.

From the foregoing it would seem that one of the devices for inducing the reserve banks to contract their issues after the need for them had passed—that is, charging interest upon such issues—is not certain, at any rate, to prove adequate; it will not surely eliminate the winter plethora in New York City which is supposed to stimulate and support excessive stock speculation. But the new law contains another provision which may be viewed as a device for supplying the issuing banks with a motive for contracting their issues, namely, the requirement that such banks shall keep a gold reserve equal to 40 per cent of their issues. Is this likely to prove effective? Probably not. Whatever might be true in panicky times, it seems certain that in an ordinary year the gold holdings of a reserve bank will be much above 40 per cent of its

note issue. If this be true, the maintenance of this 40 per cent could become difficult only when the excess of money was so great as to cause a dangerous exportation of gold from the country, and this surely would show a very inadequate degree of contractility. In short, the new law does not insure that issuing banks shall be sufficiently disposed to draw in their notes any more than it insures that outsiders will drive them in. It would seem, then, that the new law does not promise to give to the note issue the degree of contractility which has hitherto been considered desirable. In other words, there is some point in the fear expressed by many bankers that the new law will result in note inflation—at least in so far as the avoiding of this danger is dependent on the contractility of the note issue. Very likely, however, the possibility of such inflation is sufficiently guarded against by other provisions of the law.

We have discussed the adequacy of the new note issue in respect to seasonal or ordinary elasticity. We pass on now to consider its adequacy in respect to emergency elasticity—the elasticity which enables a currency to adjust itself to those extraordinary fluctuations in need which mark a banking panic and the depression that follows. Broadly speaking, it is pretty certain that at this point the new law will get a more favorable verdict than in the previous case. As pointed out in an earlier connection, the banking panic, when fully developed, gives rise to three difficulties and so to three needs: (1) funds to relieve the antecedent stringency which threatens a complete collapse of the credit structure; (2) a circulating medium for ordinary trade when a general suspension of payment by the banks has brought on a money famine; and (3) a prompt and thoroughgoing contraction of the circulation in the depression which follows the panic. Now, there surely can be no doubt that, under the new law, the availability of an issue sufficient in volume instantly to relieve the antecedent stringency, and so to put a stop to a panic before it had developed serious dimensions, is assured. In fact, it is not at all improbable that, under the new system, the reserve banks will be able to check the development of such a panic at the very outset without increasing at all their note issues. But, if this does not prove true—if it turns out that more currency is

needed for this purpose—there would seem to be no shadow of doubt that the new system will insure the forthcoming of such currency both of a quality and in a quantity which will be fully adequate to the task put upon it. (1) The notes to be issued, being obligations of the federal Treasury, will be as acceptable as gold even on the eve of a panic. (2) There is no limit to the absolute amount of these notes. (3) The practical limit set by the requirement that discounted paper shall be furnished as a basis for their issue is of no real significance, since such paper will undoubtedly be vastly greater in volume than any need which could arise. Accordingly, there can be no doubt that the new system provides all the expansibility needed to abort, or reduce to comparative harmlessness, any panic which might arise.

A word now with respect to the second need which an emergency circulation is supposed to meet, that is, an ordinary circulating medium for trade when banks have by common consent suspended payment. In the first place, if we are right in supposing that the new law will surely prevent any panic from reaching such a degree of intensity, it is obvious that we shall not have occasion to meet the particular difficulty here under consideration—that our note issue will not be called on to display this particular sort of elasticity. If, however, it be supposed that the foregoing prediction does not turn out to be correct—if experience proves that panics can still go so far as to cause banks generally to suspend payments, to hold on to every form of reasonably solid money, and to try to satisfy the public with substitutes—our verdict for the new currency would necessarily be less favorable. We should have to admit that the new law does little or nothing to relieve such a situation. Broadly speaking, the new money will be altogether too good to meet this particular need. Banks that had reached a stage of panic sufficiently intense to cause them to suspend payment—to hoard the ordinary forms of money—would be sure to hoard money as good as those notes are bound to be. That is, the new issue would immediately pass into hoards, as did the greenbacks which the Secretary of the Treasury reissued during the panic of 1873, and, therefore, would bring little if any relief to the currency famine which had developed. In fact, it is almost

impossible to conceive any form of note fitted for this particular task except one which was so bad that there was no danger of its being hoarded. That is, the only proper way to meet this particular need of a severe panic is to make sure that it does not arise at all; and, in this respect, the new law promises well.

We come, finally, to the third need which emergency elasticity is supposed to meet, that is, a prompt and great contraction of the circulation when the panic has passed and the inevitable business depression consequent upon such a panic has set in. Here, again, though not in the same degree as in the last case, if the new law proves as successful as many conservative students expect, the need in question will be little, if at all, experienced. We shall usually escape the extreme business inflation of the antepanic period; the panic itself will be much abated, if not completely eliminated; and, in consequence, the trade reaction which naturally follows a panic will be much diminished in intensity. If this turns out to be true, the circulation will never again show such an extraordinary glut as characterized the winter of 1893-94. Nevertheless, it can hardly be doubted that, after even an incipient panic, there will be some reaction, and consequently a more or less plethoric condition of the currency will follow. Will the new issue have sufficient contractility to meet this need? Earlier in this paper we have seen that the conditions attached to the new issue are in general not favorable to contractility, in that they do not provide for either the prompt driving home or the prompt drawing home of the notes when the necessity for their issue is past. Outsiders lack adequate motives for sending the notes home; issuers lack adequate motives for calling them home. The case for emergency contractility, however, is somewhat better than the case for ordinary contractility. First, it is probable that the homing power of the note will prove greater at such a time than in an ordinary year, for, at such a time, outside banks will not be able to find investments for their funds, since speculative trading will disappear altogether and business generally will be at a very low ebb. Again, it seems certain that the issuing bank will, in this case, have more than the usual motive for bringing about a contraction of the circulation. The chief reason why such a bank may not be eager

in ordinary times to hasten the retirement of its notes is the fact that, provided the notes do not accumulate in its own vaults, such a bank will gain more by using the funds in its possession to make loans than it would by using them to retire notes, assuming that the interest charge made by the Federal Reserve Board is not placed excessively high. But it is practically certain that, in the depression which follows a panic, no reserve bank will have opportunities for keeping all of its funds busy; and since, in that case, the interest charge, however small, will be a dead loss, the bank will have adequate motive for effecting, as promptly as possible, an adequate contraction of its note liabilities. This motive would be still further strengthened should the glut prove sufficient to cause a decided drain of gold, since, in that case, the reserve banks will find difficulty in maintaining the required 40 per cent reserve. On the whole, then, we seem warranted in affirming that, as respects emergency elasticity, the new notes will give no serious disappointment.

Finally, as respects elasticity in general, though the note issue, viewed by itself, does not seem quite fitted to satisfy the tests which an old-fashioned advocate of elasticity is inclined to impose upon it, yet, when we take the new law as a whole, it seems not unreasonable to affirm that it promises to accomplish, directly or indirectly, most of the ends which we had hoped to attain through elasticity and hence promises to give us a system which in essentials is truly and adequately elastic.

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